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Personal Income Tax Coordination — The Federal-Provincial Tax Collection Agreements: An Analysis of the Finance Canada Discussion Paper

ASPECTS OF PERSONAL INCOME TAXATION IN ONTARIO

Ministry of Revenue

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In 1991-92, the Ontario Ministry of Revenue reviewed several aspects of personal income taxation in Ontario. The review is comprised of six essays. They are:

1. Ontario PIT Administration by Revenue Canada, Taxation

2. The Federal-Provincial Tax Collection Agreement: How Ontario Receives Its Personal Income Tax

3. Personal Income Tax Coordination - The Federal-Provincial Tax Collection Agreements: An Analysis of the Finance Canada Discussion Paper

4. Changing Federal-Provincial Partnerships: A Comparison of the Terms and Provisions of the Canada-Quebec GST Agreement and the Federal-Provincial Tax Collection Agreement

5. Rationalizing the Personal Tax and Transfer Payment Systems: The Quebec Experience and Prospects for Ontario

6. A Compromise Solution: An Alternative to the Present Federal-Provincial Tax Collection Agreement and Establishment of a Separate Ontario PIT Administration

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SECTION 1

INTRODUCTION

Personal income taxes are levied by both the federal and provincial governments. Under the Tax Collection Agreements[1], participating provinces accept the federal structure of income taxation and, in exchange, the federal government collects the taxes for both levels at no direct administrative cost to the provinces. Ontario and all other provinces, except Quebec, have Tax Collection Agreements with Ottawa. The federal government defines virtually all aspects of the income tax structure, including:

(1) the types of income subject to tax,
(2) deductions from income, exemptions and non-refundable tax credits; and
(3) tax rates, tax brackets and indexation factors.

The Tax Collection Agreements allow provinces to make independent decisions in the following areas only:

(1) determination of amount of income tax to be raised by setting the provincial percentage of basic federal tax levied;
(2) tax credit programs (subject to federal approval), e.g. Ontario provides property and sales tax credits, the Ontario Home Ownership Savings Plan (OHOSP) tax credit and a political contribution tax credit;
(3) tax reduction programs, e.g. the Ontario Tax Reduction (subject to federal approval);
(4) provincial surtaxes; and
(5) flat taxes (certain provinces only).

The federal government receives a fee of approximately one percent of the assessed value of Ontario Tax Credits for administering the Ontario Tax Credit (OTC) program. However, it is unable (or unwilling) to carry out all necessary compliance work. For example, the federal government, while the accommodating the OHOSP program in the administration of OTC programs, will not perform any audit of OHOSP tax credits. Ontario must perform this function on its own.

The personal income tax (PIT) is the most important source of tax revenue in Ontario and, in the last few years, accounted for over 40% per cent of the province's tax revenue and approximately 33% of the total revenue. (See Appendix I for details). It is by far the largest tax paid by many individuals. It is not only a revenue-raising device for governments, but also a major instrument for providing economic incentives.

1. For a comprehensive review, refer to the essay entitled **The Federal-Provincial Tax Collection Agreement: How Ontario Receives its Personal Income Tax.**

The Tax Collection Agreements of 1962

The Agreements were designed to allow provinces to impose personal income taxes directly. The Agreements also ensure a high degree of tax uniformity among provinces and between the federal and provincial governments. The provinces, however, are allowed only to impose a single rate of tax, calculated as a percentage of basic federal tax (i.e. a "tax-on-tax").

The Tax Collection Agreements with the tax on tax framework provide:

- a high degree of harmonization, making it efficient for the federal government to administer and collect provincial PIT along with federal PIT.

- a centralized tax administration enabling taxfilers to deal with a single tax system; and

- a simplified method of calculating provincial tax liability by applying a single percentage to basic federal tax.

The greatest drawback of the tax-on-tax system is that it prevents provinces from applying their own concepts of tax equity and income redistribution; that is, it severely constrains the flexibility of provinces in raising taxes and in using the tax system to meet their social and economic priorities.

Present Situation

Under the Tax Collection Agreements, the federal government controls the tax base and thereby dictates tax policy relating to determination of income, deductions, exemptions, non-refundable tax credits, tax rates and tax brackets. Although the federal government has allowed certain purely provincial tax measures on a select basis, (e.g. surtaxes, tax reductions, tax credits and flat taxes), many provinces have found that there is insufficient flexibility to integrate their social and economic policies with their taxation policies.

NEED FOR GREATER FLEXIBILITY

The role of the PIT system has shifted, from simple revenue raising, to achieving social and economic goals. Over the years, provinces have used the PIT system as a means of delivering income support and economic incentives through tax credits. The PIT system is also being utilized for the redistribution of income through tax reductions and surtaxes. However, it is common ground among provinces that the present tax-on-tax system does not provide enough flexibility. The western provinces prepared a consensus paper in February 1989 (the Provincial proposal) outlining a tax on taxable income system (see section 2 for

details). In August 1990, the western finance ministers, in a report to their Premiers, proposed "an independent Western Canada income tax administration to ensure reasonable flexibility in provincial tax structures to respond to provincial economic and social priorities". In response to the increasing pressure, the federal Finance Minister in his budget speech of February 26, 1991, announced that a paper would be released to initiate discussion with the provinces.

THE FEDERAL DISCUSSION PAPER

On June 25, 1991, Finance Canada released a discussion paper entitled "Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements" (the discussion paper).

The discussion paper examines the current tax-on-tax arrangements and compares these characteristics with the potential dynamics of an "illustrative model", which is based on the construct of a tax-on-taxable-income approach. The analysis purports to examine on an objective basis, the advantages and disadvantages of the two models. As an aid to this analysis, the federal government has established a four-member advisory committee, chaired by Robert Brown, Chairman of Price Waterhouse of Toronto, to review technical aspects of the discussion paper, conduct public consultations and report back to the federal Finance Minister.

The discussion paper indicates that the central issue to be addressed is whether greater provincial flexibility can be accommodated through the Tax Collection Agreements without substantially reducing their value as instruments of tax harmony and simplicity. These issues affect every taxpayer from whom the federal government now collects PIT on behalf of provinces. The federal government, therefore, believes that individual Canadians and tax professionals should have an opportunity to consider the issues and provide their views. This is considered as the first step in the process of a broader consultation and discussion of the issues involved.

<u>Basic Questions</u>

The paper states that the basic questions to be addressed through the consultation process are:

(1) can the Tax Collection Agreements accommodate the increased policy flexibility that provinces are seeking without damaging the Agreements' effectiveness? and

(2) what constraints should be imposed on the new system (i.e. tax on taxable income system) in order to safeguard a national tax system, to avoid complexity and minimize compliance costs, and facilitate a single tax administration?

Tax Coordination

The discussion paper suggests that tax coordination involves achieving a balance among four objectives:

(1) harmonization,
(2) flexibility,
(3) simplicity,
(4) transparency.

(1) Harmonization

Tax harmonization ensures the absence of double taxation and uniform non-taxation of certain income (eg. one quarter of capital gains, lottery winnings). The elimination of tax-induced distortions is cited as an important factor in the efficient allocation of capital or labour.

The argument that provincial economic and tax incentives disrupt the free flow of capital and labour within the federation has little convincing force considering that:

(a) federal regional economic and investment incentives are used for this very purpose, and

(b) The Income Tax Act (Canada) provides for investment tax credits not only for capital investments but also for specific regional investments such as Cape Breton Tax Credit and certified property investment tax credit (which applies typically to property in the far north).

In reality, other factors, such as distance from market, infrastructure features such as communication and transportation facilities, and economic and social characteristics of a region, are greater determinants of capital and labour flows than are tax incentives. It should also be noted that many provinces have their own regional disparities to address (eg. northern Ontario).

(2) Flexibility

The discussion paper acknowledges the need to provide greater flexibility to provinces and, at the same time, contends that limitation of flexibility may be necessary to prevent undesirable effects with respect to tax harmonization and simplicity objectives.

The illustrative model provides a limited degree of flexibility by proposing to allow tax on taxable income instead of tax-on-tax. This limited flexibility does not allow provinces to adjust taxable income to meet provincial economic and social goals, such as addback of income from land speculation, income testing of grants, taxing 100% of capital gains or limiting certain deductions. Similarly, the federal proposal does not permit certain types of income to be subjected to a higher, or to a lower rate of tax (for example, speculation in residential property to be taxed at a higher rate, income from small business to be taxed at a lower rate, or applying Employer Health Tax to net income from self-employment).

In the final analysis, the increasing degree of flexibility required by the provinces may outweigh other considerations. What seems to be at issue is the extent to which the federal government is prepared to "loosen the reins" to satisfy provincial needs, particularly where the social or economic policy goal differs from its own.

(3) Simplicity

The "dangers" of complexity which could result from a departure from provincial tax based on the "tax-on-tax" approach are based on a narrowly-defined view of alternatives to the present arrangement. The paper discusses negative implications for both taxfilers and employers.

(a) Taxfilers

For taxfilers, the need to calculate provincial tax payable could follow a pattern similar to the one presently used to calculate federal tax payable. Rather than being new and difficult, this approach would be familiar and straightforward. The sample provincial form, attached to the discussion paper, is easy to follow. With one extra page to complete within the federal tax return kit, a provincial tax form would not be as drastic a departure from current practice as the discussion paper suggests.

(b) Employers

The spectre of multiple tables and forms for employers to use for source deductions is portrayed as a disincentive to deviate from current practice. Under the current system, there is a separate set of blended federal-provincial source deduction tables for <u>each</u> province (some employers have several sets). Under a more flexible system, administrative difficulties for employers could be mitigated. For ease of administration, it would not be beyond the powers of federal and provincial tax authorities to consolidate the effects of different federal and provincial structures into <u>one</u> set of source deduction tables for each province, similar to the present system.

(4) Transparency

The paper contends that each level of government needs to identify and disclose its proportion of the taxpayers' burden via employee pay stubs and instalment remittances to improve government accountability. There are two obvious flaws in this assertion.

First, although the tax deducted from a taxpayer's pay cheque (or remitted by instalment) may be at the appropriate provincial rate at the time of the deduction (or remittance), that rate will probably change if the taxpayer changes his province of residence before December 31st in any year. If the taxpayer moved from Ontario to Alberta on December 30th, for example, Alberta would receive all provincial tax for the year, at Alberta rates, although Ontario would be shown as the recipient province on all pay stubs (or instalment receipts).

Second, the discussion paper is silent on transparency with respect to refund cheques!

<u>SECTION 2</u>

THE FEDERAL ILLUSTRATIVE MODEL AND THE PROVINCIAL PROPOSAL: A COMPARATIVE ANALYSIS

Both the western provinces and the federal government have drafted discussion papers proposing the application of provincial tax rates directly on taxable income as opposed to levying one tax rate on basic federal tax. The following compares the current arrangement for provincial personal income taxation to the provincial and federal proposals. In addition, both negative and positive impacts of the proposed arrangements will be highlighted. It should be emphasized that the stated purpose of the federal illustrative model is to identify issues and choices -- **not to define the structure of a possible system of tax on income.**

Background

Under the Tax Collection Agreements between the participating provinces and the federal government, each province is restricted to levying only one provincial personal income tax rate on basic federal tax. The scope for a province to control its effective rate structure was initially limited, but has gradually been expanded over the years with the introduction of tax credits, tax reductions, surtaxes and flat taxes on net or taxable income, serving a variety of social and economic objectives.

The Provincial and Federal Proposals

Both the provincial and federal proposals are primarily concerned with three aspects of the tax system: the tax base, the tax rate and bracket schedule, and tax credits. (See chart entitled "Determination of Provincial Tax" on the following page.) The provincial paper tends to highlight the positive aspects of a change to tax on income from tax on federal tax, whereas the federal proposal tends to emphasize the negative aspects. The provincial paper provides a much stricter framework for tax rates and brackets and support of federal non-refundable tax credits than does the federal paper. Consequently, there are more problems inherent in the federal proposal because it is less restrictive. In addition, the provincial paper offers solutions to some of the problems addressed in the federal paper.

1. <u>The Tax Base</u>

   Both the provincial and federal proposals are predicated upon the retention of taxable income as defined by the federal government. There is no change from the current calculation of taxable income under either proposal.

DETERMINATION OF PROVINCIAL TAX

Item	Current System	Federal Model	Provincial Model
Taxable Income	federally defined	federally defined	federally defined
Rate Structure	% of federal ratio (53% for Ontario)	multi-rate, provincially defined	multi-rate, provincially defined
Brackets	3 (federally defined)	unlimited number, provincially defined	5 (additional 2 brackets)
Non-refundable Credits	% of federal amount, (53% for Ontario)	definitions federally determined, but values, thresholds set by provinces	definitions federally determined, % of support for all, additional support for 6 basic credits

2. Rates and Brackets

Currently, through the tax on "Basic Federal Tax" mechanism, the single provincial rate (53% for Ontario) is effectively applied to federal rates (17%, 26% and 29%) on up to three federally-defined brackets of federally-defined taxable income.

The provincial proposal suggests a multi-rate tax structure on federally-defined taxable income. Tax rates and brackets could vary according to provincial priorities. The provinces have proposed an additional two tax brackets, for a total of five. This is essentially the same as present effective rates, which include the three current rates, a tax reduction bracket and a surtax bracket.

The federal proposal also provides for a multi-rate tax structure on federally-defined taxable income without limiting the number of brackets and rates.

3. Non-refundable Tax Credits

Currently the provincial governments implicitly support federal non-refundable tax credits to the same extent as the tax they impose on federal tax; i.e., Ontario implicitly provides non-refundable credits that are 53% of the federal credits. With a tax on income, rather than on federal tax, the provinces would have the flexibility to determine the degree to which they wish to support federal non-refundable tax credits.

The provincial proposal suggests a minimum level of provincial support for the non-refundable tax credits to which all provinces would conform, such as 40% of the value of the total federal non-refundable credit block. In addition, the provinces would retain the flexibility to augment this support by introducing additional assistance, limited to six of the sixteen federal credits; namely,

- basic,
- spousal (and equivalent to married),
- dependent children,
- age,
- disability, and
- other dependants.

The federal proposal suggests the provinces adopt the federally-defined block of non-refundable credits but establish their own value for these credits and set their own income thresholds and reduction rates.

ADVANTAGES AND DISADVANTAGES OF PROPOSALS

Advantages

Provincial and Federal Proposals

- o Would enable some provincial priorities to be accommodated within the joint collection system.
- o Would enhance the collection of statistical data for the provinces and improve their ability to generate economic forecasts and formulate tax policy.
- o Would improve accountability, transparency and flexibility.
- o Could simplify the tax system by reducing complex calculations currently necessary to achieve provincial policy objectives, e.g., tax reduction.

  Comment:

  May reduce complexity but would increase the number of calculations to be made.

- o Would clarify tax calculations since provincial tax would be expressed as a percentage of taxable income rather than a percentage of federal tax.
- o Would provide a solution to the problems arising from flat taxes. (Not applicable to Ontario as flat taxes have not been implemented.)
- o Would free the federal government from having to factor in net provincial tax implications of changes in federal "take".

Federal Proposal

- o Federal changes to non-refundable tax credits need not impact on provincial revenues.

  Comment:

  This is not the case with the provincial proposal since it recommends supporting all federal non-refundable tax credits by a minimum percentage.

Disadvantages

Provincial and Federal Proposals

- o The federal model provides greater potential for divergence between federal and provincial governments and among provinces.

  Comment:

  The provincial model offers less potential for divergence; e.g., recommends only five brackets, recommends a specified degree of support for all federal non-refundable tax credits. Nevertheless, the western provinces see this as providing flexibility to accommodate provincial policies.

- o A revised tax rate structure may affect the free flow of capital across Canada and may affect labour mobility within Canada.

  Comment:

  Regional disparities already exist. Changes as a result of tax rate structure may improve rather than adversely affect conditions, depending upon tax policy chosen by individual provinces. The provincial model provides less likelihood of these problems by restricting the tax brackets to five; the federal model suggests unlimited brackets.

- o Tax on income system may affect Canada's competitiveness; i.e. too great a differential will result in the emigration of high-income earners.

  Comment:

  Such concerns already exist with the present system. Changes to other taxes, such as corporations tax or the goods and services tax, might have a greater impact than changes to the personal income tax. Opportunities to emigrate to a more favourable tax jurisdiction are usually limited for individuals who are not self-employed. Individual provinces would be sensitive to migration implications of harsh tax increases.

- o Calculations would not be as simple since additional steps would be required of the taxfiler.

  Comment:

  This is particularly true of the federal model which proposes that the provinces

determine the full extent of participation in federal non-refundable tax credits. The provincial proposal recommends a percentage overall plus additional participation in six of the sixteen credits; therefore, while additional steps would be required, there might be fewer than with the federal model. In addition, while there would be more calculations, they would not necessarily be more complex.

- o Additional administrative work and costs would be required of employers, taxpayers and Revenue Canada, Taxation.

  Comment:

  Benefits to taxpayers may outweigh the additional costs involved. Revenue Canada, Taxation could negotiate a change in administrative fees.

- o Although there will be increased work for taxfilers, the new system may not necessarily be more transparent; i.e., taxfilers may still not be aware of the provincial component on their tax forms. However, the federal paper suggests that a clear separation of federal and provincial taxes on the tax return, and separate federal and provincial calculations on instalment payments and pay slips could alleviate this problem.

  Comment:

  In addition, those who benefit from provincial credits and refunds would be likely to recognize provincial components.

- o Problems would arise with dividend tax credits, minimum tax carry-overs and overseas employment tax credits.

  Comment:

  See comments on key technical issues (Section 3).

SECTION 3

COMMENTS ON KEY TECHNICAL ISSUES

Non-Refundable Credits

Description

- The block of non-refundable credits is a tax preference shared with the federal government, consisting of:
  - personal credits (basic, married or equivalent, child, disability, age);
  - expense credits (CPP contributions, UI premiums, tuition fees, education expenses, medical expenses);
  - other credits (charitable donations, pension income); and
  - transfers (spousal, child).
- Currently the amount of these credits is reduced to 17% to arrive at their value as a deduction from federal tax in arriving at Basic Federal Tax.

Federal Proposal (Illustrative Model)

- In the Illustrative Model, the block of credits would remain identical with definitions and eligibility criteria set federally. The provinces would control the value of the credits, the income thresholds and reduction rates and the amount of the unused portion of allowable credits which may be transferred from a spouse or child.
- Finance Canada feels it is necessary to maintain consistency in the tax system so eligibility criteria for the credits is established at a federal level. Further, they feel that constraints on the minimum value for each credit and the transfer of credits to eligible persons are necessary.
- Finance Canada suggests a minimum value be established in order to prevent inequitable treatment of taxpayers in similar situations in different provinces. Also, there is concern that situations may arise relative to the transference of unused portions of credits whereby taxfilers may be dependants and taxable in their own right, simultaneously. This, potentially could create inequities (taxpayers in similar situations being treated differently) and result in compliance and administrative problems if uniform measures are not adopted.

Comments

- o The provincial paper also suggests a minimum level of support for the entire block of credits with the ability to enhance basic, spousal, child tax credit and other dependant credits, age and disability credits.

- o The ability to control the value, thresholds, reduction rates, etc. of non-refundable credits might have a positive impact on Ontario revenues. The cost of these credits in foregone Ontario revenues was estimated to be in excess of $4 billion in the 1988 taxation year.

- o Allowing the provinces to control values, reduction rates, etc. would provide greater flexibility and accountability in tax policy.

- o The right to modify non-refundable credits would allow provinces to pursue discrete social and economic priorities. This would not necessarily create inequities from a national perspective, but rather could remedy existing regional disparities.

- o The provincial proposal, to support all federal non-refundable credits and permit augmentation, would allow some flexibility to pursue provincial policies.

Dividend Gross-Up and Credit

Description

- o Dividends are paid to individuals from after-tax corporate profits.

- o The dividend tax credit is intended to alleviate theoretical double taxation (corporate and personal), compared to the receipt of income received directly by an individual.

- o The credit mechanism is intended to ensure that business income bears the same overall tax burden, whether it is received directly (by the self-employed) or indirectly (by a corporation, then distributed as dividends to shareholders). It also encourages investment in Canadian corporations, as foreign dividends are ineligible for the credit.

- o The grossed-up credit is used to calculate taxable income.

- o The Federal Dividend Tax Credit deduction is made before arriving at basic federal tax. Therefore, Ontario taxes are indirectly reduced as a result of the dividend tax credit.

Federal Proposal

- o The grossed-up dividend is included in arriving at taxable income. The credit is deducted in arriving at Basic Federal Tax. To preserve the intent of the mechanism, provinces would have to provide an equivalent provincial tax credit.

- o If a provincial dividend tax credit is to be established, it must be uniform from province to province.

Comments

- o The provincial proposal suggests establishing a uniform provincial dividend tax credit at a percentage of the federal credit.

- o This avoids tax competition and maintains integration between personal and corporate tax systems.

- o The provincial paper addresses the federal concerns in this area.

Alternative Minimum Tax (AMT)

Description

- o The AMT is intended to ensure that high income earners pay their fair share of tax by limiting the effect of certain tax preferences e.g. capital cost allowance on MURBS and film properties, rollovers to RRSPs, etc.

- o A deduction of $40,000 is provided to create an "adjusted taxable income". Tax is calculated by applying the minimum tax rate (17%) against this tax base. Revenue Canada, Taxation's system calculates both tax due under normal rules and that due under AMT - the greater is assessed.

- o As designed, AMT is really a prepayment of tax at regular rates. A seven-year carry-forward of AMT is provided for potential credit against regular tax payable in subsequent years.

- o Ontario tax is reduced as a result of any AMT credit from previous years, since the deduction is made before arriving at basic federal tax.

Federal Proposal

- o The key concern is to prevent potential erosion of the mechanism, assuming that each province would set its own rules for tax credits.

Comments

- o The provincial paper supports minimum tax and mirrors the federal calculation.
- o The provincial rates to be applied for credit calculation could be achieved by levying a standard provincial rate or paralleling the individual tax rates of the federal government.
- o The provincial paper does not anticipate a significant departure from the current system, especially if the federal calculation is adopted. However, if the provinces were to adopt differing rates or treat the AMT in different ways, the seven year carry-over would have potential to create problems related to taxpayers' mobility interprovincially during the seven year period.

Forward Averaging (Carry-Over Provisions)

Description

- o Forward averaging, abolished in 1988, will not be phased out until 1997.
- o Forward averaging allows reimbursement in one taxation year of taxes paid in previous years.

Federal Proposal

- o Key concerns are that provinces provide a mechanism to ensure tax credits are available for amounts forward averaged in prior years and that the provinces reimburse each other when forward averaging withdrawal takes place in another province.

Comments

- o The provincial paper also provides that, until 1997, a forward averaging credit be allowed for amounts prior to 1988 which are brought back into income. It also

ensures that the tax credit will be calculated at the top marginal tax rate for the province in the year it is claimed, provided the top marginal rate is also federal policy.

- Reimbursement to other provinces could take place in a manner similar to that now used by Ontario Corporations Tax. World income is taxed as though it were earned in Ontario. Tax on business income earned in other jurisdictions is then prorated and allocated back to the jurisdiction of origin.

- The provincial proposal recognizes problems with carry-over provisions, particularly in multi-jurisdictional situations. By agreeing to the continuance of the forward averaging credit and the assurance of a top marginal rate, it somewhat alleviates the federal concerns. Residency should be studied, nonetheless.

Treatment of Multi-Jurisdictional Taxpayers

Description

- Currently, all income (other than business income) is taxable in the province in which an individual resides on December 31st of the taxation year. In multi-jurisdictional instances, for taxpayers carrying on business in more than one province, basic federal tax is allocated among the provinces, based on the proportion of business income earned in each province, according to a formula set out in the Income Tax Act.

- The taxpayer then multiplies the amount of basic federal tax allocated to each province by the appropriate provincial tax rate to determine the provincial tax liability in each province.

Federal Position

- Finance Canada's concern is that a tax on income would create a disruption in the appropriate base of allocation since basic federal tax is no longer used to calculate provincial tax.

- There is concern that a multi-jurisdictional taxpayer may only be taxed at the lowest provincial rate if allocating taxable income between provinces were not carried out conscientiously.

- This situation would be contrary to tax progressivity of the current system.

Comments

- o The provinces suggest that total national (world) income be used to determine gross tax payable in each province. The amount would be prorated downward to obtain actual tax payable for each province, thereby protecting tax progressivity application.

- o This method provides flexibility, e.g. credit values can also be prorated downward.

- o As with carry-over provisions, the provincial paper allows that the issue of residency must be studied before establishing methods to deal with multi-jurisdictional taxpayers.

SECTION 4

ALTERNATIVES TO TAX-ON-TAXABLE INCOME MODEL

The provinces' and the federal government's discussion papers deal with the application of provincial tax rates directly on taxable income. The following presents alternatives to this method both within the realm of the Tax Collection Agreement and beyond the scope of the Agreement.

Alternatives Available Under The Existing Tax Collection Agreement

1. Flat Tax

- In 1985, the federal government agreed to administer a flat tax for the province of Saskatchewan on a temporary basis. It was later expanded to include Manitoba and Alberta. Ontario has requested a flat tax and a two-tiered surtax, both of which the federal government refused to administer.

- A flat tax, such as in the Saskatchewan system, is a single rate applied to federally defined net income.

- Flat taxes are major revenue-raising instruments which have a significant impact on provincial tax burdens and rates. A single rate levied on net income (rather than taxable income) provides a substantial increase in revenues because the net income base can be so much greater than taxable income.

- Flat tax is the same percentage of income at all income levels; therefore, it runs counter to the principle of progressivity which is inherent in the current personal income tax system.

- However, a portion of flat tax revenues can be used to augment or enhance refundable credit programs, thereby negating any regressive effects.

- The federal government raises the issue of "transparency" which stems from a concern that the provinces will increase their tax take while the federal government will be blamed for these tax increases.

- In his 1991 report, the Auditor General requested that Finance Canada review and report on the "experimental" use of flat taxes.

2. Flat Tax - Credit Income

- An alternative to a straight flat tax is a linear rate structure that combines a constant marginal rate (perhaps on net income) with a substantial personal credit and few exemptions or deductions.

- Under this system all individuals would start out with a credit. A uniform tax rate is applied to a comprehensive income base and the effective rate of tax would rise with incomes. The amount of the credit can be based on the poverty line, so that up to that amount an individual would receive a credit since the amount of their credit outweighs their tax payable.

- This tax system is progressive at the lower end of income classes and is equitable to higher income ranges since taxes relative to income are magnified much more at incomes from $10,000 to $20,000 than at those from $100,000 to $500,000. (See Credit Income Tax Table, Appendix II.)

- The flat tax/credit income tax is flexible enough to allow for the imposition of surtax at the higher end of the taxation scale.

- Some of the benefits of a flat tax/credit income include:
  - ease of administration (as a result of fewer or no deductions/exemptions);
  - ease of withholding for employers (with a flat rate for all);
  - fewer opportunities for tax evasion, due to the broader application of withholding;
  - no need for tax brackets or indexing of the brackets.

- Further, the credit income tax automatically rebates credits at a level lower than the poverty line. This provides a mechanism for using the taxation system to serve a social welfare agenda.

- Progressive taxation system wherein average or effective rates of tax would increase steadily with income.

- As the credit is fixed and relatively less important for high-income taxpayers, the average tax rate rises with income even though the marginal rate remains constant.

- The credit income tax automatically extends down into the negative range by providing transfers to those with lower incomes. This method of integrating the tax and transfer systems could also provide the basis for a modification of tax credit, tax reduction and welfare systems that would integrate them more fully with the PIT system.

Alternative Outside the Scope of the Tax Collection Agreement

Self Administration of the Income Tax System

- The single greatest benefit of an autonomous system would be the flexibility to use the tax system as a tool to pursue the social and economic agenda of the government of the day.

- The administrative requirements of such a change would be significant. Mandatory programs (e.g. enquiries, procedures, forms, filing, accounting and control etc.) and enforcement programs (e.g. collections, audit etc.) would have to be established. Significant personnel requirements, such as training, would also have to be undertaken.

- The administrative costs of such a measure were estimated in 1983 to be 1.9 percent of Ontario PIT revenues. Start up costs would also be significant, for plant and systems hardware and development.

- A province adopting its own PIT system would have to bear the cost of bad debts. Under the Agreement, the federal government now bears this burden. However, the amount of interest and penalties assessed is very significant. Such non-tax revenues are currently retained by the federal government under the Agreement.

An Ontario Solution Within the Tax Collection Agreement

Ontario-Assessed Returns Within Federal Tax Return

- As an alternative to the option of withdrawing from the present arrangement, Ontario could develop a method of achieving its social and economic agenda, while <u>staying within</u> the Tax Collection Agreement.

- An essay on the mechanics of how this might be accomplished will be outlined in the concluding work in this series.

SECTION 5

CONCLUSIONS

Conclusions

- o The federal paper is directed to an audience wider than provincial tax agencies; therefore, it is difficult to predict the outcome of the consultation process.

- o Although the discussion paper proposes increasing provincial flexibility by permitting tax on taxable income, it still restricts provinces to the current federal income tax structure. Flexibility is provided regarding non-refundable tax credit items only. It appears that policy options involving extraction of an "above the line" item and applying a surtax or tax credit to it below the line are not open to provinces.

- o The federal paper emphasizes the transparency issue and the need for accountability of the two levels of government on documents relating to deductions at source and payment of instalments. The paper, however, is silent on transparency with respect to refunds. It would appear that the mechanics exist in the proposal for attribution of refunds between federal and provincial levels, yet no suggestions are made for transparency on refunds.

- o The paper contends that provinces are receiving a "free" tax administration service from the federal government. Such is not the case. Under the terms of the Agreement, the federal government receives:

    - all arrears interest on overdue taxes;
    - all fines and administrative penalties; and
    - significant cash-flow advantages.

  In addition, the federal government receives approximately one percent of Ontario Tax Credits for administering that program.

  The amounts of non-tax revenue from these sources are controllable entirely by the federal government and these are becoming an increasingly lucrative method of extracting additional revenue. It is true that the federal government absorbs all provincial bad debts. These losses are reduced by the terms of the payment schedule of the Agreement. Delays between initial remittances by employers and receipt of provincial portion by provinces and delays in instalment payments to provinces by the federal government result in the federal government keeping large amounts of provincial tax revenues for lengthy periods (up to 27 months).

Taking into account the interest provinces are losing on these funds, it is not entirely correct that provinces are recipients of a "free" tax administration. On the contrary, Ontario may be subsidizing the federal administration of the personal income tax system beyond the costs attributable to Ontario. For a detailed analysis of cost implications for Ontario, refer to the essay entitled **The Federal-Provincial Tax Collection Agreement: How Ontario Receives its Personal Income Tax.**

- Finally, considering the fact that approximately 40% of Ontario's tax revenue is derived from personal income tax, it should not be surprising that Ontario would wish to have more control over policy issues relating to its major source of income. The increasing degree of flexibility required by the provinces in general, and by Ontario in particular, may far outweigh other considerations.

PERSONAL INCOME TAX (PIT) REVENUE

PIT AS A PERCENTAGE OF

Year	ONTARIO'S		QUEBEC'S		FEDERAL	
	Total Taxes	Total Revenue	Total Taxes	Total Revenue	Total Taxes	Total Revenue
	%	%	%	%	%	%
1987-88	43.9	30.4	48.8	33.2	61.3	55.0
1988-89	43.3	31.4	48.8	33.2	59.9	53.5
1989-90	43.5	32.4	47.6	32.9	57.9	51.8
1990-91	45.9	35.5	50.3	35.2	60.7	48.9
1991-92	47.5	37.1	48.7	33.9	62.2	49.9

Source: **The percentages are estimated based on information extracted from the Provincial and Federal budgets. Federal Total Taxes and Total Revenue for 1990-91 and 1991-92 include G.S.T.**

APPENDIX II

CREDIT INCOME TAX TABLE

Credit = $3,000   Tax Rate = 30%

Income	Tax	Credit	Net Tax	Net Tax As a % Of Income
0	0	3,000	-3,000	N/A
1,000	300	3,000	-2,700	-270%
5,000	1,500	3,000	-1,500	-30%
10,000	3,000	3,000	0	0%
20,000	6,000	3,000	3,000	15%
50,000	15,000	3,000	12,000	24%
100,000	30,000	3,000	27,000	27%
500,000	150,000	3,000	147,000	29%

Source: Douglas G. Hartle et al, A Separate Personal Income Tax for Ontario: An Economic Analysis, Ontario Economic Council, Special Research Report, 1983.

DATE DUE
